Research Department
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September 26, 1980

FRBSF Weekly Letter

China: Money and Banking

China is in the midst of a massive modernization program. The program's success will depend on many factors, among them being the development of a modern monetary and banking system that can assist the nation in attaining its goal of rapid and stable growth. Thus, as a basis for appraising the nation's economic prospects, it would be useful to examine China's present monetary policy and banking structure.

Money and prices

Chinese officials claim that China — unlike most other countries — has succeeded in keeping domestic prices relatively stable over the past three decades. They admit to a few lapses, such as in 1956, 1960-62, and more recently in 1979, when prices had to be raised because of "transient factors." However, they contend that those exceptions prove the rule: after each lapse, prices always returned to roughly the original level. China's urban-consumer retail-price index rose only by 15 percent between 1952 and 1978, indicating an average inflation rate of only 0.5 percent a year over that quarter-century. Even more remarkable, the index showed a 7-percent decline between 1962 and 1978.

It is difficult to evaluate this claim. Unlike prices in a market economy, prices in China are fixed by the planning authorities and do not work to clear the market. Any inflation pressure would show up in shortages and long queues, not necessarily in price increases. Nonetheless, in an era of worldwide inflation, it is remarkable that basic commodities such as grains, meat, clothing, and housing cost no more in China today than they did twenty years ago.

Chinese-government officials explain that the key to their apparent success lies in a coordinated approach towards balance between monetary growth and output growth. In China, monetary policy is an integral part of overall economic planning. Each year the central-planning authorities obtain inputs from the various sectors of the economy and develop three major plans covering output, manpower and finance. The financial plan is composed of three segments — the state budget, the credit plan, and the cash plan — which fit together to determine the targeted growth in the money supply.

During the year, the monetary authorities monitor money growth, while the economic commission keeps track of output developments, and both submit aggregated monthly and quarterly reports to the central-planning commission. By July of each year, when nearly all the crop estimates are in, the planning authorities make a judgment on what adjustments, if any, need to be made in either monetary growth or production and distribution plans. Adjusted plans are then drawn up for the second half of the current year, and these also serve as a basis for formulating plans for the next year.

China, like other socialist countries, follows a strict monetarist approach to monetary policy, but of a 19th-century vintage — that is, an analytical framework derived from the simple quantity equation, PQ=MV. (The price level times the total output of goods and services — that is, GNP — equals the money supply times the income velocity of turnover of that money supply.) With the assumption of relatively stable V, monetary policy consists of adjusting M for a given Q in order to attain price stability. Interestingly, the monetary authorities define money to include only currency in circulation, and not bank deposits held by the public. They use this narrow definition because, in their view, bank deposits are not "checkable" and hence cannot be used as a means of payment.

In the absence of hard statistical data, it is difficult to determine how well the simple quantity-equation approach and the restricted money-supply definition have served in

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implementing China's monetary policy. However, the justification must lie partly in the planning process in which the monetary policy is embedded. As China shifts away from a rigid planning process and as individual enterprises gain greater autonomy in the management of their financial affairs, the authorities undoubtedly will begin rethinking these basic tenets of monetary policy.

Domestic banking

Changes are also occurring in domestic banking. A single institution — the People's Bank of China, with 15,000 offices and 330,000 employees — still dominates the nation's domestic banking activities. However, there are now three specialized banks, which have expanded their activities in the past year or two. The Construction Bank, until recently a bank in name only, has begun experimenting with loan operations in the basic-construction field. The Agriculture Bank, after a number of ups and downs, began operating early last year on a reorganized basis in the rural area. the Bank of China is basically a foreign-exchange bank and handles all the nation's financial transactions with foreigners. All four are government banks and nominally operate directly under the State Council, the government's highest administrative organ. In fact, however, the People's Bank of China is the first among equals in the banking system; it supervises the operation of both the Bank of China and the Agriculture Bank, while the Construction Bank functions under the joint supervision of the Ministry of Finance and the State Construction Commission.

Although the banking system is all-encompassing, traditional banking (in the sense of deposit-taking and credit-extension activities) occupies but a relatively small fraction of total financing. That is because all financing is disbursed through the banks, but mainly in the form of state-appropriated funds, which are about three times as large as banking funds from both private and public sources.

State-appropriated funds generally pay for plant, equipment, and infrastructure construction, as well as regular ("quota") working-capital needs of all enterprises. In disbursing these funds, the banks serve as the government's fiscal agent, being responsible for insuring that the enterprises' financial transactions are carried out as planned. Until recently, these funds were provided free of interest and repayment obligations. Financing by bank loans until recently has been limited to meeting enterprises' "supra-quota" working-capital needs, such as those arising from seasonal fluctuations in activities, temporary gaps in cash flow, and so on. In fact, because of the relatively low loan-interest rate (5 percent or less per year) and the tight constraints on state-appropriated funds, enterprises have a strong incentive to borrow from banks and use the funds for non-prescribed purposes. As a result, a considerable amount of bank staff's time and energy is occupied with policing this kind of "misuse" of loan proceeds.

Today, however, this system is undergoing rapid and drastic change. Besides reestablishing the Agriculture Bank and upgrading the hierarchy of the Construction Bank and the Bank of China within the government structure, the authorities also have begun gradually to substitute bank lending for state-budget financing. This is part of an overall policy of greater reliance on the market and less on planning in the conduct of economic activities. The shift began in 1979 on a limited, experimental basis, and has since gone considerably further.

International banking

China's international finance follows the same planning process as domestic finance. Each year, the Bank of China — together with the Ministry of Foreign Trade, the Ministry of Finance and other state agencies — submits a foreign-exchange plan for the following year. Once the plan is approved by the State Council, the Bank of China becomes responsible for monitoring and administering the plan under the general supervision of the People's Bank of China.

Government officials take pride in the fact that China has incurred little external debt since the repayment of her heavy debts to the Soviet Union in the early 1960's. Nevertheless, the world's financial markets became intensely aware of China's presence in 1978 and 1979, when China negotiated about $28 billion in foreign credits, ostensibly to finance her anticipated huge capital-import program. More recently, however, China has drastically reduced her ambitious investment plans, and has begun to shift investment priorities from heavy industry to agriculture, light industry, housing and transportation. Chinese government officials continue to emphasize their desire to import modern technology and equipment—but only to the extent that the nation can pay through exports or can borrow comfortably with little debt burden. So far, China has drawn only to a very limited extent on its huge foreign credits, and has relied largely on government-guaranteed export credits with subsidized interest rates. The authorities seem anxious to avoid incurring large amounts of external debt, especially during the current period of high interest rates.

In the international-banking community, the earlier euphoria about lending prospects has passed; in its place is a more realistic appraisal of China's financial needs and absorptive capability. A few banks have gained a strong foothold in the China market — especially the Japanese and the British, who have been in this business much longer than the Americans, and hence have much greater familiarity with the market. Others have not done so well; some have lost money in the process. Still, most international bankers remain cautiously optimistic about long-run prospects, counting on the day in the not-too-distant future when China emerges from the present adjustment period, with reformulated investment plans, and again seeks large-scale financing.

In the meantime, with the exception of a few large projects (such as a huge hotel and trade-center project in Beijing), current interest in the banking community seems to focus on joint-venture and compensation-trade arrangements. (The latter are arrangements whereby the exporter receives payments in goods to be produced by the equipment shipped under contract.) Both types of arrangements involve considerable risk to all parties, including the lenders. Inevitably, in order to compensate the lenders for the large credit risk, the cost of financing is higher than usual. The cost must be absorbed either by the exporter or passed on to the importer, by means (e.g., pricing the export equipment) which may not always be obvious to the importing side.

Overall, China is undergoing considerable change as it proceeds with its "Four Modernizations." Monetary policy and banking policy, like other aspects of the national economy, will certainly be strongly affected by this modernization process. In the monetary and banking field, as in other fields, the critical question remains: how far can market forces be used to improve economic efficiency within a socialist planned economy?

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 9/10/80	Change from 9/3/80	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	139,173	− 254	5,954	4.5
Loans (gross, adjusted) — total#	117,408	− 191	7,309	6.6
Commercial and industrial	34,042	− 39	2,200	6.9
Real estate	47,544	216	7,075	17.5
Loans to individuals	23,707	− 53	488	2.1
Securities loans	1,013	11	− 1,062	− 51.2
U.S. Treasury securities*	6,408	− 83	− 1,330	− 17.2
Other securities*	15,357	20	− 25	− 0.2
Demand deposits — total#	48,175	709	1,703	3.7
Demand deposits — adjusted	33,415	575	2,282	7.3
Savings deposits — total	29,539	1	− 1,023	− 3.3
Time deposits — total#	63,605	542	9,984	18.6
Individuals, part. & corp.	55,230	382	10,056	22.3
(Large negotiable CD's)	24,118	349	4,224	21.2

Weekly Averages of Daily Figures	Week ended 9/10/80	Week ended 9/3/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	− 21	− 8	− 9
Borrowings	136	133	60
Net free reserves (+)/Net borrowed(−)	− 156	− 141	− 69

* Excludes trading account securities.
# Includes items not shown separately.

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